

## **IFRS15:**

An accounting change with profound impacts for communications operators—from the P&L to operations, pricing and marketing



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Most accounting changes never come to the attention of the CEOs or operational management – instead they're dealt with by specialist accounting professionals or perhaps the CFO. But the new IFRS15 accounting standard on revenue recognition, published jointly by the International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB), is an exception. Due to start coming to force from the start of 2018, IFRS15 significantly changes mobile operators' long-standing practice of quietly using customers' service plan charges to subsidise the up-front costs of their handsets. As a result, it brings profound implications for communications companies' operations, with knock-on effects on areas from pricing to marketing to sale incentives. And while the looming deadline set for the introduction of the new standard is a date that no operator can afford to miss, many have yet to start their compliance programmes.

## By Christoph Gruss and Holger Miß

In May 2014, when the IASB and FASB jointly issued their converged IFRS15 standard and the respective US GAAP standard on the recognition of revenue from contracts with customers, they described their shared goal as being to “improve the financial reporting of revenue and improve comparability of the top line in financial statements globally.”<sup>1</sup>

According to the IASB and FASB, the previously differing requirements of both IFRS and US GAAP often resulted in different accounting treatment being applied to transactions that were “economically similar”. They added that while IFRS’s existing revenue recognition requirements lacked sufficient detail, the accounting requirements of US GAAP were regarded as overly prescriptive and conflicting in certain areas.

To address these issues, the two boards had worked together and consulted widely over a period of about a decade. Through this process they developed new requirements for the recognition of revenue in both IFRS and US GAAP—opening the way to what they hailed as “substantial enhancements to the quality and consistency of how revenue is reported, while also improving comparability in the financial statements of companies reporting using IFRS and US GAAP.”

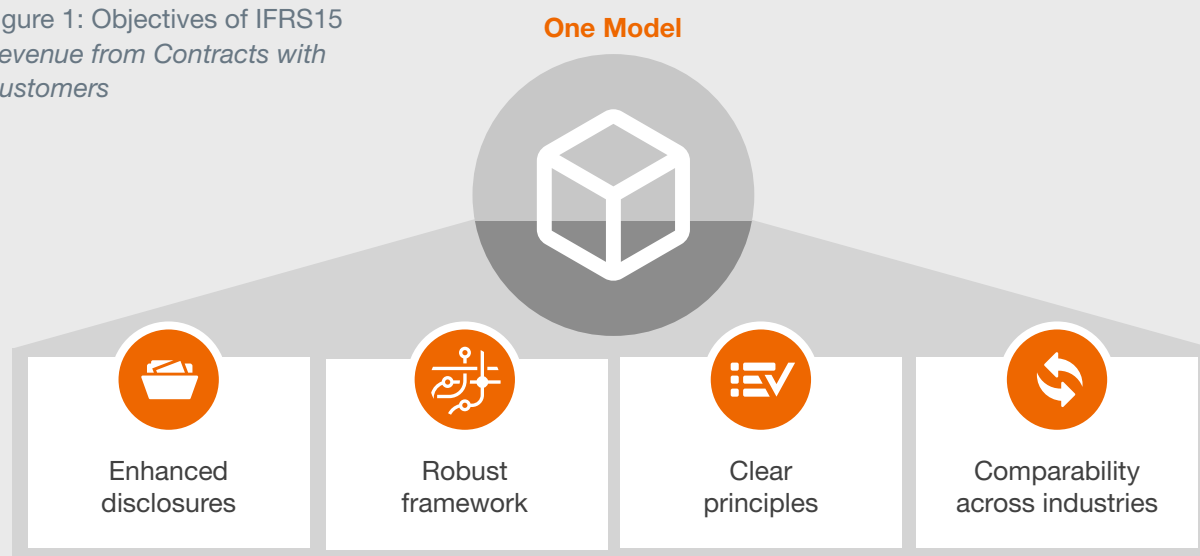
At the time of the announcement, the deadline set for companies using IFRS to apply the new revenue standard was for reporting periods beginning on or after 1 January 2017, while public companies using US GAAP would be required to apply it to annual reporting periods beginning after 15 December 2016. However, in July 2015 the IASB and FASB confirmed a one-year deferral of these effective dates, giving IFRS companies a deadline of 1 January 2018, and US GAAP companies a deadline of a year earlier.

### Core principles

So, what changes does the new IFRS15 standard bring about? The core principle behind the standard is that entities should recognise revenue from the sale of goods or services to customers that reflects the payment made to the company in exchange for those goods or services. And it looks to apply this principle universally by putting in place a single, consistent model for recognition of revenue in companies across every sector.

As Figure 1 shows, this model is underpinned by the enhanced disclosures about revenue, a robust framework for these disclosures, clear principles to guide accounting

Figure 1: Objectives of IFRS15  
*Revenue from Contracts with Customers*



*And while businesses across the industry are at various stages in preparing for IFRS15's introduction, it's clear that many face a race against time to get their systems and processes ready in time for the change.*

treatment of revenue, and a new level of comparability across different industries. The two boards pointed out that the specific benefits of their respective new standards would include new guidance for transactions that were not previously addressed comprehensively – such as service revenue and contract modifications – and better guidance for multiple-element arrangements.

### **The accounting implications for communications operators...**

While the principles behind the new standard are clear and explicit, its impacts are wide-ranging and – in some cases – potentially unexpected. It is the first major new standard in years, and will result in unprecedented changes in the way revenue is recognised. And while many industries will be affected to varying degrees, the types of business models used in the communications industry mean the impacts on operators will be arguably greater and more profound than for virtually any other type of business – with just about every revenue generating entity being affected in some way.

The pressure is increased by the tight deadline for implementation of the new standard. As this is a regulatory change – and one that has already been delayed by a year – being late in implementing it is not an option. Any company that misses the relevant deadlines<sup>2</sup> will face regulatory sanctions and reputation damage for failing to comply with accounting standards – which is something every business must strive to avoid. And while businesses across the industry are at various stages in preparing for IFRS15's introduction, it's clear that many face a race against time to get their systems and processes ready in time for the change.

### **...have become a major issue for operations and the board**

This combination of tight timeframe and sweeping implications has seen the issue of IFRS15 compliance escalate from the operators' accounting functions to become a significant item on the boardroom agenda. And a closer look shows clearly why this is the case.

Since IFRS15 is about revenue recognition, it inevitably affects the biggest number on operators' P&L: revenue. And while the actual change itself only involves accounting standards and regulation, understanding its impacts for an operator requires a detailed knowledge of what happens on the operational side of its business.

What's emerged is that IFRS15 is a change that cannot be dealt with solely within the accounting team. Instead it demands input, decisions and changes on the operational side as well – because that's where its biggest impact arises. What's more, its effect extends from the Accounting & Reporting function across the entire business, requiring changes to processes & system, business models, and at a cross-functional level in areas including Sales & Legal, HR, and Tax.

### **A key area affected: handset subsidies...**

The easiest way to appreciate these impacts is through a practical example common to most operators. Perhaps the clearest of these involves the handset subsidy model that's used today by mobile operators in most markets around the world.

Most readers may know this already, but here's a brief description of how the handset subsidy model works in simple terms. Under it, the customer is offered a high-value smartphone handset – which might cost, say, US\$600 to buy as a standalone item – for a nominal

price of a few dollars or even free of charge. However to get the handset for this price, the customer has to sign a fixed-term contract for a service package covering calls and data, as an example for a two-year period. If the customer wants to end this contract early during this period, he or she will have to pay a fee to cover the remaining handset costs.

From the customer's point of view, the fact that they're paying almost nothing up front for the handset is a big attraction. In fact, however they know that they do pay for the handset over time – but through service charges that are higher than they would have been if no handset were provided.

### **...creating seismic impacts in markets worldwide**

This handset subsidy model has served the global telecoms market well for many years, and has been a major factor in the rapid growth of service penetration and revenues in markets worldwide. It's also a business model that is relatively easy to manage from an accounting perspective. This is because the systems currently in place simply recognise whatever the customer pays as revenue. And under a "billing date accounting" approach, you account for the revenue you recognise at whatever time the customer pays it.

But IFRS15 rips this well-established model apart, by requiring operators to carry out a "relative fair value" allocation between the handset and the service. This means shifting revenue away from the service element and reallocating it to the handset. So instead of recognising €1 of revenue for the handset, the operator might recognise €100, balanced by a corresponding and equal reduction in the total service payments the customer will make over the term of the contract.

### **Challenges around IT systems**

It remains open to question whether this new approach benefits customers. But at least it sounds like a change that should be relatively simple from an accounting perspective. However, in practice it's far more complicated to apply than it would appear – because the accounting systems currently in use by operators across the world were not designed to handle and automate a switch of revenue recognition from service to handset.

What's more, communications operators with hundreds of millions of contracts will have to reflect this new accounting model hundreds of millions of times. As a result, it's not only a major pricing, marketing and customer relationship management issue but also a major IT and operational issue. Yet the irony is that the amount ultimately paid by the customer remains unchanged.

### **Industry responses to date...**

The overall outcome is that IFRS15 represents a huge business challenge for operators. The new standard has effectively reversed the traditional accepted dynamics, under which accounting should follow the business model. Instead, this is an accounting change that will trigger significant system and process changes, because the existing systems environment may not be able to handle it. And it means that changes to business models themselves are also on the horizon.

It may be of little comfort to communications operators that other industries are also being effected by accounting regulators' move away from cash accounting. Examples include retailers offering a second item for half price, or printer manufacturers who subsidise a low-cost printer by selling higher-priced cartridges for it. But nowhere are the impacts greater than in telecoms.

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## ***As the full ramifications of IFRS15 continue to play out, what steps should operators be taking to ensure they're in the best position to comply?***

As a result, widespread discussions are under way within operators about whether they should stop some business models because of the complexity of the accounting. And to date they have begun to respond in a number of ways. One is to end the use of subsidies for handsets, and instead split the contract explicitly between the handset and service components, so the customer pays a separate amount for each element every month. Another approach is to finance the handset in a different way so the customer pays for it over a period of time.

### **...are continuing to evolve, as the full impacts emerge**

As operators plan and implement such responses, their approaches are being shaped not only by the regulatory imperative to comply with IFRS15, but also by a number of industry-specific factors with wider business implications.

For example, one of the most important key performance indicators (KPIs) tracked by management and investors in the communications services industry is average revenue per user (ARPU). Since ARPU is driven by the revenue from services, recognising a slice of that revenue for the handset instead can have the effect of reducing ARPU – and thereby also reducing customer profitability year on year. With this impact in mind, operators are looking to develop business models that keep their service charges as consistent as possible to protect their annual ARPU comparisons.

A further area that's affected is sales incentives. If IFRS15 changes the revenue recognised as the result of a sale, then the incentive plans for salespeople will also need to be modified to reflect this. If this isn't done, then the salespeople's behaviour will change, possibly not in the way the business wants.

Tax issues may also arise. Tax in multinational communications service providers is driven largely by revenue in the local territory accounts, which tends to reflect the current rules. The possible difference between top-line IFRS or US GAAP numbers and local territory accounts might impact taxation and financial planning.

### **A five-step approach for addressing the IFRS15 challenge**

So, as the full ramifications of IFRS15 continue to play out, what steps should operators be taking to ensure they're in the best position to comply – while also minimising the degree of disruption to their business? The ISAB developed a five-step model to help companies manage the conversion of existing and future contracts to IFRS15 accounting. The five steps are summarised in Figure 2 – and here are the main points of each step:

## We urge operators to plan and launch their IFRS projects as an immediate business priority.

### **Step 1: Identify the contract(s) with the customer–**

This means establishing what contracts you have with customers. IFRS15 provides clearer guidance on what to do if a contract is assessed as being unlikely to be collectible, and also has specific guidance on contract modifications.

### **Step 2: Identify the separate performance obligations in the contract(s)–**

A performance obligation can be summarised as “a promise in a contract with a customer to transfer a good or service to the customer.” Key questions here are whether a good or service is “distinct”, “integrated”, or “homogeneous”.

**Step 3: Determine the transaction price–** The transaction price can be defined as the “amount of consideration to which entity expects to be entitled in exchange for transferring goods or services.” It may be affected by factors including variable consideration, financing components, non-cash consideration, and consideration payable to customers.

**Step 4: Allocate the transaction price–** This means thinking through the “fair value” of the handset and service components, and carrying out a relative fair value allocation between the two. For example the operator might allocate €100 of the total consideration to the handset performance obligation and the rest to the service.

**Step 5: Recognise revenue when (or as) a performance obligation is satisfied–** Here the operator decides at what point in time control over the good or service transfers to the customer, and when to recognise the relevant revenue. This can either be over time – for example by measuring progress towards complete satisfaction of the performance obligation – or at a specific point in time.

### **Moving towards compliance**

We’re aware of several operators that have yet to begin their journey to IFRS15 compliance. Given that the deadline is unlikely to move any further back, we would urge these players to plan and launch their IFRS projects as an immediate business priority – or they may face challenges around being ready in time.

Aside from the compliance deadline itself, a further consideration is the need for SEC registrants under US

Figure 2: IASB Guidance



GAAP and IFRS to have two prior years of comparative revenue data to set alongside the new IFRS15 accounting treatment. For non SEC registrants, by contrast, the requirement is one year of prior comparative data. Also, all companies face substantial additional disclosure requirements, including for information about opening and closing contract balances and remaining performance obligations at the end of the accounting period.

## Conclusion: a puzzle that can't be solved through accounting alone

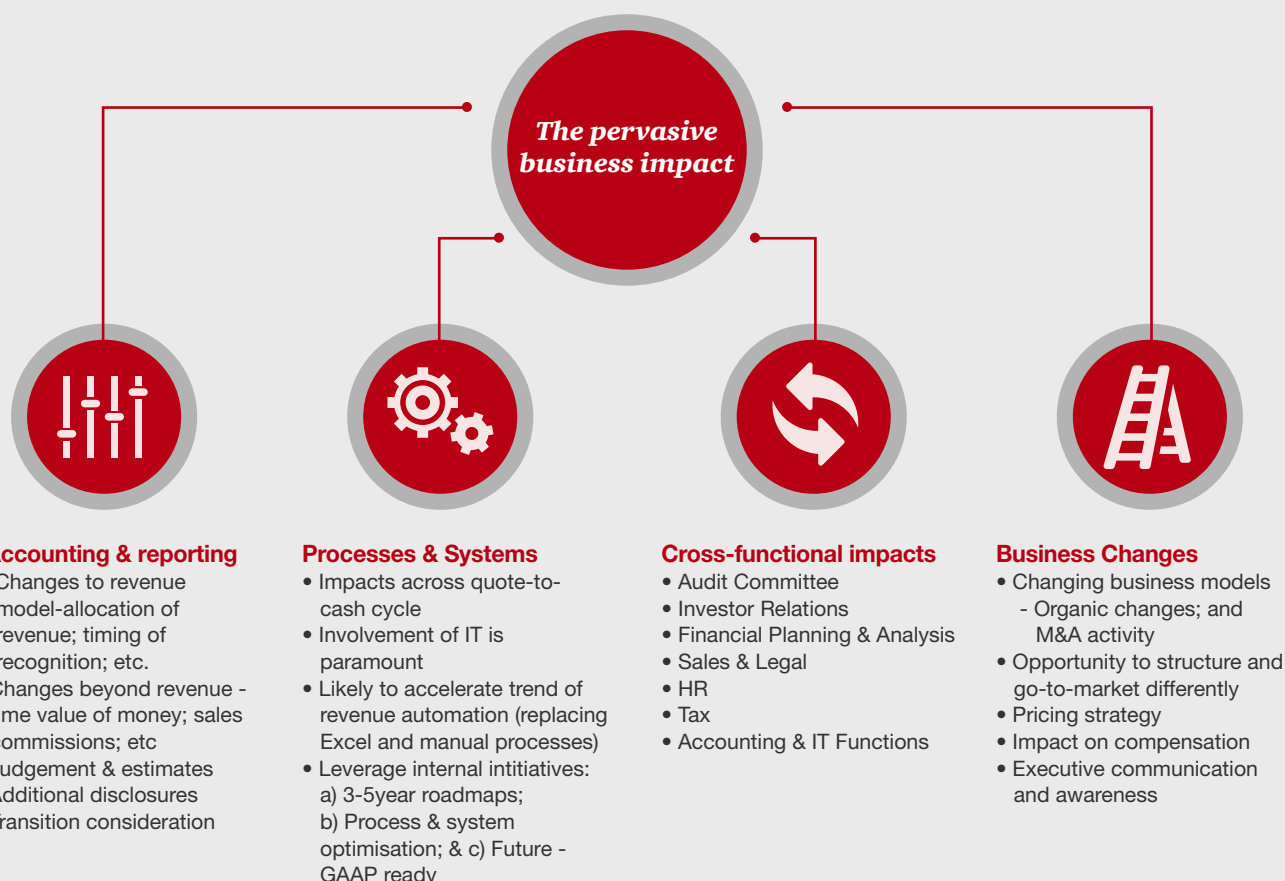
Overall, the message is clear: for communications operators worldwide, adapting their business and operations to IFRS15 is a challenge that the accounting team can't be left to tackle alone. In fact, accounting is only one aspect of the IFRS15 puzzle. Figure 3 illustrates the reach and scope of IFRS15's pervasive business impacts.

With IFRS15, accounting has come decisively out of the back office – and is driving operators to change their front-office business models. While this may look like

a case of the tail wagging the dog, for some operators the cost of their IFRS15 adaptation projects may deliver business benefits beyond achieving regulatory compliance. For example, the need for greater standardisation and centralisation under IFRS15 may enable global operators to gain higher transparency and control over their local territory operations around the world.

But whatever the risks and benefits, the fact is that IFRS15 is imminent – and operators need to take action now to understand and prepare for its impact. Put simply, there's no time to lose.

Figure 3: The pervasive business impacts of IFRS15 in a communications operator



## Endnote

1. IASB and FASB press release: <http://www.ifrs.org/Alerts/ProjectUpdate/Documents/2014/PR-IFRS-15-Revenue-recognition-May-2014.pdf>
2. [http://www.fasb.org/jsp/FASB/Page/BridgePage&cid=1351027207987#section\\_7](http://www.fasb.org/jsp/FASB/Page/BridgePage&cid=1351027207987#section_7)  
<http://www.ifrs.org/Alerts/PressRelease/Pages/IASB-confirms-deferral-of-effective-date-by-issuing-formal-amendment-to-the-revenue-Standard.aspx>

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